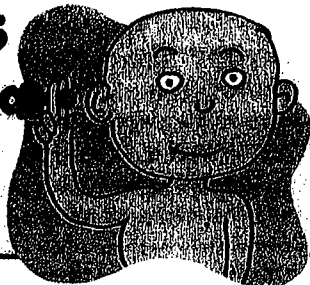


Tax Traps and Opportunities in Making Loans To Your Kids

Albert Ellentuck, Esq., CPA
King & Nordlinger, LLP



Many parents want to help their children buy a house, start a business, or meet some other need for cash. Sometimes, a loan is more practical than an outright gift.

Today's low-interest-rate environment makes intrafamily loans attractive, not only to borrowers, but to parents who can make below-market loans to kids at a time when the alternative is a meager return from a CD.

However, care should be taken to avoid tax traps.

when loans equal gifts

If you make a formal loan to a child and collect a market rate of interest, you probably won't incur tax problems.

Trap: Many parents make interest-free or low-interest loans to their children. Such loans may have gift and income tax consequences.

Under the Tax Code, foregone interest must be "imputed" (implied) on loans between family members at the applicable federal rate (AFR).

Example: In April 2005, Joe Brown loaned \$200,000 to his daughter Ann, payable in nine years. No interest is being charged.

Loans of three to nine years are considered midterm loans. In April 2005, the AFR rate used by the IRS for midterm loans was 4.09%.

Result: The imputed interest is \$8,180 (4.09% of \$200,000) per year. Each year, Joe must recognize for tax purposes \$8,180 worth of interest

income. He also is deemed to have made an \$8,180 gift to Ann each year on which she pays no interest.

Tax break: Ann may get an \$8,180 interest deduction each year.

Example: Ann uses the \$200,000 to buy a business (an S corporation with \$200,000 of assets). If she had paid her father interest on the loan, and itemized her deductions, she could have deducted that interest.

Therefore, she can deduct interest she never actually paid.

What if Ann pays, say, 2% interest on this loan—\$4,000 per year? This is still 2.09 percentage points below the AFR, so \$4,180 worth of imputed interest would have to be recognized by Joe and, perhaps, could be deducted by Ann in addition to the \$4,000 of interest actually paid.

exceptional treatment

With interest rates currently at modest levels, the tax consequences of below-market loans aren't as harsh as they would be with higher rates.

Nevertheless, you may benefit by avoiding some of the tax consequences if you qualify for either of two exceptions.

Exception 1: If the cumulative amount of below-market loans to a

Tax Hotline interviewed Albert Ellentuck, Esq., CPA, of counsel to the law firm King & Nordlinger, LLP, 2111 Wilson Blvd., Arlington, Virginia 22201. Past chairman of the Tax Division of the American Institute of CPAs (AICPA), he writes a monthly tax column for the AICPA publication, *The Tax Adviser*.



given child doesn't exceed \$10,000 at a given time, no interest will be imputed.

Required: The loan can't be used to buy income-producing investments.

Example: Joe Brown also lends his son Bob \$10,000 so Bob can buy a car. No interest is charged.

Since this loan falls within the \$10,000 limit, no interest must be imputed, so there will be no tax consequences.

Caution: Say Bob uses only \$5,000 to buy the car and puts the other \$5,000 into a bond fund. There will be imputed interest on the \$5,000 that's invested.

Assuming the AFR is 4.09%, as above, the annual imputed interest would be \$205 (4.09% of \$5,000).

Joe (the lender) would have to recognize \$205 of taxable income while Bob (the borrower) might have a \$205 deduction.

Exception 2: This exception applies to larger loans. If the loans from one family member to another don't exceed \$100,000, there will be no income tax consequences.

Required: The child's net investment income must be no more than \$1,000 each year. Generally, this refers to interest and dividends.

Example: Suppose Joe lends Ann only \$100,000 to buy a condo. For the year, Ann reports \$150 in income from interest on a bank account and mutual fund dividends. She's under the \$1,000 allowance, so this loan has no tax consequences.

But what if Ann's investment income is above the \$1,000 limit? Suppose she has \$2,500 in interest and dividend income this year. Since she's over the limit, interest will be imputed, but will total no more than her investment income.

In this example, only \$2,500 worth of interest income would be imputed to Joe, the lender. (Ann has \$2,500 of investment income, so that's the maximum for imputed interest.)

That's true even if Ann pays no interest on the loan and the foregone interest, based on the AFR, is \$4,090, or 4.09% of \$100,000.

Trap: If loans to a given borrower total more than the \$100,000 exception even by a few dollars, the exception won't apply. On a \$110,000 loan, for example, all the foregone interest would have to be added to Joe's taxable income.

Key: The amount of interest income that's imputed to the lender can be deducted by the borrower, if the requirements for deducting interest are met.

gauging the gift tax

The two exceptions noted at left (for loans of up to \$10,000 and \$100,000) relate to income tax consequences, not to gift tax consequences.

The foregone interest on a below-market loan is treated as a gift. Fortunately, the annual gift tax exclusion applies to such gifts.

Current level: Everyone can give up to \$11,000 per person in 2005 to any number of recipients. (The dollar limit may be adjusted for inflation in the future.) With interest rates at current levels, this exclusion might eliminate the need to pay gift tax.

Example: As above, if no interest were paid on a \$200,000 loan that was made when the AFR was 4.09%, the imputed interest would be \$8,180 per year. If no other gifts were made by the lender to the borrower, the \$11,000 exclusion would cover all the foregone interest.

Result: No gift tax need be paid.

Trap: If the lender makes gifts to the borrower that year of \$11,000, besides making the loan, the fore-

gone interest would not be fully covered by the exclusion—creating a taxable gift.

savvy strategies

The lower the level of interest rates, the less painful the tax consequences of making a below-market loan to your child. *Nevertheless, certain steps can avoid tax traps...*

•**Formalize the loan.** Both parties should sign an agreement spelling out the terms of the loan, and those terms should be followed.

Trap: Without a formal loan agreement, the IRS may re-cast the entire transaction as a gift, which could require a substantial payment of gift tax.

•**Observe the exceptions.** If possible, try to keep loans below the \$10,000 and \$100,000 levels, as explained above. Avoid making loans of, say, \$10,500 or \$110,000.

Key: If you are lending your child between \$10,000 and \$100,000, keep the child's investment income down. The child might invest any surplus cash in growth stocks (many of which pay little or no dividends), rather than in bank CDs or bonds.

•**Consider demand loans.** A loan that is payable in full at any time, rather than after a certain number of years, is a demand loan. Such loans are considered short-term by the IRS so the interest rates may be lower.

In April 2005, for example, when the midterm AFR was 4.09%, the short-term rate was only 3.35%. On a \$200,000 loan with no interest paid currently, the foregone interest imputed as income to the lender would be only \$6,700 per year, instead of \$8,180. **TH**